BANK ACCOUNTING PRIMER

An Information Package (IP) is prepared on a failing financial institution in order to present financial data to potential acquirers. The IP Schedule 101, Balance Sheet, should present only the legally collectable (or for some assets, historical cost adjusted for depreciation) or payable balances of assets and liabilities, respectively, that may be transferred to an acquirer. Due to time and personnel constraints, DOR must rely on the bank's financial accounting systems and operations to provide data. DOR is not charged with auditing the financial records, however, we should question discrepancies between the records and supporting documents and try to reconcile the two.

In most circumstances, only a general level of understanding of accounting is required of IP/AVR team members. A common level of accounting knowledge will aid in understanding bank operations, IP preparation, and how RAVEN's general ledger functions and relates to other RAVEN databases.

Purposes of Bank Accounting

Bank accounting and reporting systems are designed to provide information for potentially four major purposes with often conflicting or redundant goals. Because creditors and investors in a bank often are not involved in daily operations to the same extent as management, they rely on financial information prepared and presented according to generally accepted accounting principles (GAAP). GAAP reflects the effects of economic transactions on the business enterprise expressed in monetary terms. The federal bank regulators (the Federal Reserve System, Office of the Comptroller of the Currency, and the FDIC) require reporting of financial information conforming to regulatory accounting principles (RAP). Banks that have publicly traded securities registered with the Securities and Exchange Commission (SEC) must meet the SEC's reporting requirements, and senior management will impose its own requirements of the bank's accounting systems to provide relevant information for decision-making purposes. The regulatory agencies, including the SEC, will generally follow GAAP unless specific oversight or enforcement roles necessitate a modification.

A bank's accounting and reporting system's output are the financial statements. The GAAP financial statements are the Balance Sheet (Statement of Financial Position), the Statement of Income (Statement of Earnings), the Statement of Changes in Stockholders' Equity, and the Statement of Cash Flows. The Balance Sheet is a "snapshot" of a bank's financial position at a point in time and reflects the "accounting equation," Assets = Liabilities + Stockholder's Equity. The Statement of Income reports the profitability of a bank for a stated period of time and displays the equation, Revenues - Expenses = Net Income. The Statement of Changes in Stockholders' Equity is a summary of the transactions affecting the accounts in this section of the Balance Sheet for a stated period of time. The Statement of Cash Flows provides relevant information about the cash receipts and cash payments of a bank during a given period.

The Accounting Equation

The basic accounting equation, again, Assets = Liabilities + Stockholders' Equity, shows the

relationship among assets, liabilities, and equity. Because recording of each transaction must leave the equation in balance, the debits and credits posted to accounts must equal. This is the core of double entry accounting systems. The equation must always be in balance, however as economic activity is recorded, the relative composition of these three categories changes. As an example, assume the following transactions for RAVEN Bank, Nevermore, IA.:

a) receives a $5,000 deposit
b) makes a $2,000 loan
c) pays $1,000 in dividends
d) increase reserves for loan losses by $500

Accounting Equation:	Assets	=	Liabilities	+	Equity
Typical balance will be:	Debit(Dr.)		Credit (Cr.)		Credit
Transactions:					
Beginning balances:	$100,000	=	$90,000	+	$10,000
a) Dr. Cash & Due From	+5,000	=			
Cr. Deposit Liability		=	+5,000		
Revised balances	$105,000	=	$95,000	+	$10,000

Note: To record acceptance of a $5,000 deposit.

b) Dr. Loans	+ 2,000	=			
Cr. Cash & Due From	- 2,000	=			
Revised balances	$105,000	=	$95,000	+	$10,000

Note: To record booking of a new loan funded with cash.

c) Dr. Retained Earnings		=			- 1,000
Cr. Cash & Due From	-1,000	=			
Revised balances	$104,000	=	$95,000	+	$ 9,000

Note: To record payment of dividends on day declared.

d) Dr. Provision for Loan Losses		=			- 500
Cr. Allowance for Loan Losses	-500	=			
Revised balances	$103,500	=	$95,000	+	$ 8,500

Note: To provide for additional loan loss reserves.

Note several important points regarding the transactions:

1) Each transaction has a dual effect on the equation, that is, at least two items change, but not necessarily on both sides of the equation.
2) After each transaction is recorded, the equation remains in balance, A = L + SE
3) Expenses, in this example provision for loan losses, decrease stockholder's equity through the income statement which is closed to the retained earnings account within stockholder's equity at the end of the accounting period.
4) Dividends decrease stockholders' equity directly.

As you can see from the preceding illustration, recording transactions as increases and decreases in accounting equation items could become quite burdensome for a bank, which typically processes thousands of transactions each day. Instead, transactions are recorded using separate accounts for each asset, liability, and item of stockholder's equity.

Accounts

An account is an element in the accounting system that is used to classify and summarize money measurements of business activity of a similar nature. Accounts will typically carry a debit (Dr.) or credit (Cr.) balance.

The chart of accounts list accounts, with numbers and titles, grouped into the major classification of asset, liabilities, stockholders' equity, income and expense. The level of detail, that is, the number of accounts, required in each classification depends on a variety of factors including the following: 1) regulatory reporting requirements, 2) internal management reporting requirements, 3) level of automation, and 4) products and services offered by the bank. A bank may modify its chart of accounts to accommodate its particular needs at any given time; therefore it may be useful to review in order to determine current and past activities in which the bank may have engaged. The chart of accounts may use a numbering scheme which permits flexibility to add accounts to appropriate categories without renumbering the entire chart. As an example:

Assets	1000
Liabilities	2000
Subordinated Debt	3000
Equity Capital	4000
Not Used	5000
Income	6000
Expenses	7000
Income Taxes	8000

(As will be demonstrated, RAVEN captures the failing bank's active accounts from the general ledger input and assigns a RAVEN account number, also.)

For demonstration purposes, it is helpful to think of each account as a T-account, derived from the fact that it looks like the letter "T." Computerized accounting systems use the concept of the T-accounts, but not the format. They use pluses and minuses. Increases are entered on one side of the T-account and decreases are entered on the other side. Debits are always on the left and credits are on the right, however whether a debit or credit increases or decreases an account's balance depends on the account's category, i.e. asset, liability, equity, income, or expense.

Accounting Equation:	Assets	=	Liabilities	+	Equity
	Dr. Cr.		Dr. Cr.		Dr. Cr.
	+ | -		- | +		- | +

Income	Expenses
Dr. Cr.	Dr. Cr.
- | +	+ | -

Note that the debit and the credit positions do not change; only the plus and minus signs. Therefore, for every transaction recorded, debits always equal credits for the equation to remain in balance. Income and expense accounts are increased and decreased with respect to their effects on stockholders' equity. Income increases stockholders' equity; therefore, income is recorded as a credit. Expenses decrease stockholders' equity; therefore, expenses are recorded as debits. To summarize:

	ASSETS	LIABILITIES	EQUITY	INCOME	EXPENSES
Bal. is usually:	Debit	Credit	Credit	Credit	Debit
To Increase:	Debit	Credit	Credit	Credit	Debit
To Decrease:	Credit	Debit	Debit	Debit	Credit

Caution should be exercised when reviewing entries or reports as to what format a particular institution shows its account balances. In one type of format, credit entries and balances will be shown as negative numbers with an asterisk (*), minus sign (-), or in parenthesis (). In another format no sign is used to indicate whether the account balance or entry is a debit or credit. The reviewer is expected to know what type of account is shown and whether its normal balance is a debit or credit.

Source Documents, Journals, and Ledgers

Almost every transaction creates a source document, which is any written or printed evidence of a business transaction that describes the essential facts of the transaction. Examples are checks, notes, deposit slips, and debit or credit tickets. A source document initiates the process of recording a transaction. Transactions are first recorded in a journal, which is a chronological listing of transactions. A journal entry would appear as follows:

Date
Account Name (Debit) xx
Account Name (Credit) xx
Description of transaction

After a transaction is recorded in the journal, the debit and credit amounts are posted to the appropriate accounts in the general ledger, which is a collection of all the accounts. (Generally, banks do not maintain a journal due to the large volume of transactions to be recorded. They retain descriptive debit and credit tickets for this purpose.) The accounts in the general ledger are those listed in the bank's chart of accounts. In some cases, the amounts are actually posted twice, notably in the case of loan and deposit accounts. The amount is posted once into a general ledger control account and once into a subsidiary ledger, which shows the details supporting the related general ledger control account. A control account is a general ledger account that shows the total balance of all the subsidiary accounts related to it. Examples of control accounts would be loans and deposits. Examples of subsidiary ledger accounts would be John Smith's loan detail, or Jane Doe's deposit account detail.

Accounting Information Processing Cycle

The accounting information processing cycle is a series of procedures performed during the accounting period to analyze, record, classify, summarize, and report useful financial information. The first three steps are performed during the accounting period. The remaining steps are performed at the end of the accounting period. The collecting and processing procedures are called a cycle because they are repeated each accounting period for the new economic data. The steps in the accounting cycle are:

1. Analyze transactions by examining the source documents.

   Each transaction must be analyzed to determine its effects on the accounting equation, Assets = Liabilities + Equity. Recall that the equation must remain in balance. For non-reoccurring transactions it is helpful to have the chart of accounts available to use as a reference in determining the appropriate accounts to be affected.
2. Record transactions in the journal (debit/credit tickets).

After the transactions have been analyzed, the effects of each are entered into the accounting system in the journal. Because the journal is the place where a transaction is initially recorded, it is called the book of original entry. Recording the transactions in the journal is called journalizing and the entries are called journal entries. Again, in the banking industry the journal entries typically take the form of debit and credit tickets that reflect the date, account number affected, account name (optional), description of the transaction so recorded, and dollar amounts. These tickets are retained for some period of time.

3. Post (transfer) data from the journal to the accounts in the general ledger.

   The debit and credit amounts recorded in the journal are posted to the indicated general ledger accounts. Whereas the journal lists the dual effect of each transaction in one place, the general ledger records the debits and credits for each transaction in two or more accounts. The general ledger arrangement of accounts classifies data as assets, liabilities, stockholders' equity, income, and expenses. This reclassification of data facilitates the preparation of the financial statements.

4. Prepare an unadjusted trial balance of the accounts.

   At the end of the accounting period, an unadjusted trial balance is prepared directly from the general ledger accounts. A trial balance is a listing, in ledger account order, of the individual accounts and their ending debit or credit balances. The ending balance of an account is the difference between the account's total debits and total credits, including its beginning balance, if any. The trial balance serves two purposes, to provide a check on the equality of the debits and the credits and to provide financial data in a form convenient for preparing the financial statements covering the accounting period.

   The Daily Statement of Condition is a trial balance of all the accounts in the general ledger as of the close of each business day and, as such, reflects the daily financial position of a bank (except that certain accruals may not be recorded). This report is used for internal management purposes. In addition to proving the equality of the debits and the credits, the Daily Statement of Condition is used by management to check for large errors, to detect early warnings of trends, and to aid in cash management and reserve maintenance.

5. Record and post the adjusting journal entries.

Journal entries are initiated during an accounting period, adjusting journal entries are made at the end of the accounting period. They typically are made to adhere to GAAP mandated accrual basis accounting, which requires application of the accounting principles of revenue recognition and matching. The revenue recognition principle says that revenue ("income" in bank terminology) is recognized when it is earned, which means the bank has done substantially what it was required to do to earn the income. An example is interest income on loans that is earned daily during the life of the loan, but is not collected in cash until some later date (IENC = Interest Earned, Not Collected). The matching principle requires that expenses be matched with the income they produce during the accounting period. Accordingly, banks match loan losses with the interest income they produce. The time period (periodicity) assumption postulates that an entity's life may be subdivided into short time periods, say months or years, for purposes of reporting the entity's economic activities. This practice creates complex accounting problems, because some transactions start in one accounting period and are concluded in a subsequent period. For example, depreciation on buildings is recorded at the end of each accounting period to match acquisition costs of the building with the income earned during each period of its life. The time period assumption makes necessary the adjusting entries prepared under the accrual basis of accounting.

Adjusting journal entries are journal entries made at the end of an accounting period to match income (revenue recognition principle) and expenses (matching principle). These special entries bring all accounts up to date (time period assumption) so that correct financial statements can be prepared. Adjusting entries are grouped into the following two classes and four types:

A. Prepaid items
   1) Prepaid income (recorded as a liability account)
   2) Prepaid expense (recorded as an asset account)
B. Accrued items
   3) Accrued assets
   4) Accrued liabilities and contra assets

6. Prepare an adjusted trial balance of the accounts.

After the adjusting entries have been posted to the general ledger, an adjusted trial balance should be prepared to ensure the equality of the debits and the credits.

7. Prepare the Statement of Income.

   The Statement of Income presents the equation, Income - Expenses = Net Income. Net Income is expanded to include gains on the sale of assets and the meaning of expenses included similar losses. Income is reported on a "net interest income" basis, that is, interest expense is deducted from interest income. Highlighting this amount makes the statement more useful because of the importance of net interest income to bank profitability. Deducting the provision for loan losses from net interest income is another convention for making a bank's Statement of Income more informative.

8. Record and post the closing entries.

   The purposes of closing entries are to close the income and expense accounts to Retained Earnings and to establish a zero balance in each of the accounts to start the next accounting period. The closing entries must be made after the Statement of Income is prepared.

9. Prepare a post-closing trial balance of the accounts.

10. Prepare the Balance Sheet, the Statement of Changes in Stockholders' Equity, and the Statement of Cash Flows.

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